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Budget Blues. *Two years ago, budget surpluses were confidently expected. Today, towering deficits are a major worry. What went wrong? Causes are sorted out, remedies suggested.* 1

Economy Watch. *The business pace is showing signs of perking up. Latest quarterly projections, sector by sector.* 7

Flow of Funds. *Credit demands—from business, consumers, government—will reach $515 billion this year, up 4% from 1982. Detailed estimates—and where the funds might come from.* 9

Natural Gas. *Everyone's unhappy—users, producers, the pipelines. Prices are up. Wells are being shut down. Factories are switching back to oil. Blame it all on rigid regulations.* 12

Economic Indicators 15

Budget Arithmetic: Behind the Dilemma

THE rapid deterioration of the fiscal outlook has bred discouragement in financial markets and among the public as well. President Reagan's forthcoming budget message is expected to project deficits of close to $200 billion in both fiscal 1984 and 1985. Moreover, there is concern that the deficit could grow even larger in the mid-1980s.

Apprehension about the prospect of swollen deficits in 1984 and beyond is particularly evident in the credit markets. Already, the Treasury is borrowing unprecedented amounts—an estimated $188 billion in the current fiscal year (table on page 2). Market participants worry that while such borrowings are manageable this year because of reduced private-sector credit needs (story on page 9), they could prove destabilizing when the economy moves into higher gear.

The present fiscal outlook is radically changed from that of two years ago. Part of the problem is purely cyclical in character, reflecting unexpectedly weak economic performance. But that still leaves a whopping cyclically adjusted or "structural" deficit. Sorting out the different elements that have contributed to deterioration over the past two years is an essential first step to solving the budget dilemma.

To determine just how much leeway existed for policy innovation, the President's advisers early in 1981 estimated the budget's likely evolution over a period of years if all federal programs and tax statutes remained unchanged. That so-called baseline—or current-services—projection (upper panel of the chart on page 3) indicated a $67-billion surplus by fiscal 1984 and

Outlook for Federal Borrowing

(Billions of dollars)

	1982	*1983*			*Fiscal*	*Fiscal*
	*Q4**	*Q1**	*Q2**	*Q3**	*1982*	*1983**
Receipts	135.8	141.5	179.8	155.1	617.7	612.2
Outlays	203.0	196.7	196.0	196.3	728.4	792.0
Deficit (on budget)	−67.2	−55.2	−16.2	−41.2	−110.7	−179.8
Deficit (off budget)	−2.0	−3.6	−4.4	−4.1	−17.3	−14.1
Total deficit to be financed	−69.2	−58.8	−20.6	−45.3	−128.0	−193.9
Means of financing:						
Net cash borrowed from public	+61.2	+53.0	+23.1	+50.3	+134.9	+187.6
Change in cash balance†	−9.4	−7.8	+1.0	+7.0	+10.5	−9.2
Other‡	−1.4	−2.0	−1.5	+2.0	+3.8	−2.9
Cash balance at end of period	19.8	12.0	13.0	20.0	29.2	20.0

*Estimated by The Morgan Bank.
†A negative implies a drawdown in the cash balance and, hence, represents a source of Treasury financing.
‡Includes float and deposit fund balances.

a $111-billion surplus by fiscal 1985.* The main reason was the high efficiency of the progressive income tax in generating revenue.

These baseline surpluses caused Administration officials to conclude that both the tax reduction and the military buildup that were pledged by Mr. Reagan in the 1980 campaign could be prudently undertaken. So long as nondefense spending was curtailed and real GNP growth averaged 4% to 5%, they argued, small budget surpluses could still be realized in fiscal 1984 and fiscal 1985 (middle panel of the chart on page 3).

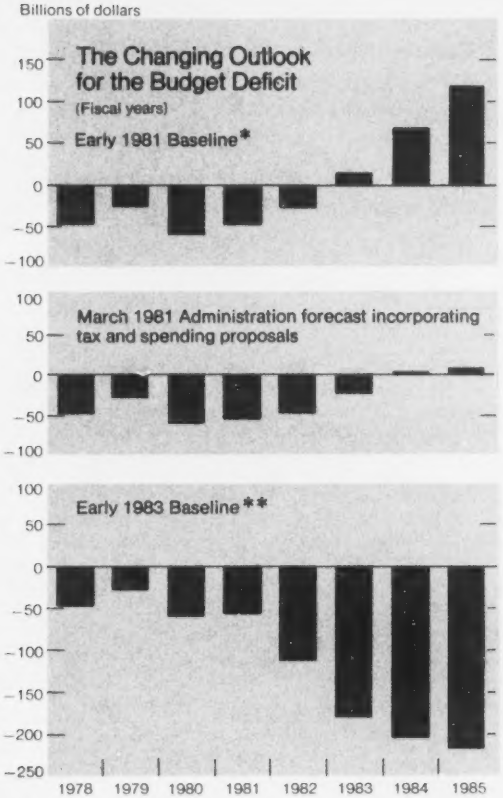
Things, of course, have not worked out as expected. Baseline projections made today (bottom panel of chart on page 3) bear no resemblance to the budget trajectory Administration officials forecast two years ago. The Morgan Bank projects the baseline deficit for the current fiscal year at $179 billion—far from the near-balance that the Administration had hoped to achieve. The projected deficit rises further to $203 billion in fiscal 1984 and to $218 billion in fiscal 1985, or almost 6% of GNP—a post-World War II record.*

The table on page 3 quantifies the influences that have transformed the baseline budget outlook so substantially over the past two years.

Multiple surprises. The main contributors have been the weak economy and the lower-than-expected inflation that has accompanied it. The Administration in the spring of 1981

*The baseline concept assumes no policy change and the continuation of current programs at present levels.

*The 1983-85 estimates are based on The Morgan Bank's economic outlook, which assumes moderately paced recovery for real GNP in calendar year 1983 at 3.8%, fourth quarter to fourth quarter. In contrast, the Administration's forecast for real GNP growth during 1983 is just over 3%. The difference between the Administration's deficit forecast ($190 billion) for fiscal 1983, as reported in the press, and The Morgan Bank estimate ($179 billion) thus is explained by different economic assumptions. Both Morgan and the Administration estimate real GNP growth of 4% to 4½% during 1984 and 1985.



* Budget surplus or deficit expected in the absence of policy changes and assuming current programs are continued into the future.

** Data for 1982 are actual. Plottings for 1983-85 are estimates, which are based on The Morgan Bank's economic assumptions.

forecast a rise in real GNP of 5.2% in 1982. Its inflation forecast called for a 7.2% rise in consumer prices. Real GNP probably declined by 1% in 1982, and the CPI rose only 4.6%. Personal income and corporate profits, as a result, were each more than $100 billion lower than the Administration expected. Thus, surprisingly poor cyclical performance and unexpectedly good inflation experience, together with higher-than-anticipated interest rates, explain a substantial portion of the differences between current baseline budget projections and those of early 1981. Of the total increase of $193 billion in the estimated fiscal 1983 baseline deficit, some $131 billion, or 67%, is attributable to the fact that economic activity, inflation, and interest rates have followed a different path from that expected in 1981. The impact on the deficit (caused by recession and the moderate recovery in prospect) lingers into 1984 and 1985. Additionally, the almost $280-billion increase in public debt, resulting from huge deficits of the past few years, adds to the problem because of a permanently increased interest burden.

Tax and spending changes. Government actions are notably less important than is the recession in explaining baseline deterioration since early 1981. Still, government actions have been significant. The Administration's hopes of

Why the Deficit Has Grown

(Fiscal years; billions of dollars)

	1982	*1983*	*1984*	*1985*
Government actions	**−17**	**−50**	**−80**	**−136**
Tax reductions (net)*	−38	−74	−101	−134
Defense increases	−6	−21	−27	−50
Nondefense spending cuts	+27	+45	+48	+48
Differences due to changed economic outlook	**−60**	**−131**	**−165**	**−163**
Weaker economy and lower inflation	−43	−106	−132	−128
Higher interest rates†	−17	−25	−33	−35
Technical reestimates‡	**−6**	**−12**	**−25**	**−36**
Net effect on baseline projections	**−83**	**−193**	**−270**	**−335**

Note: Minus signs represent increase in deficit.
*Net effect of 1981 and 1982 tax law changes.
†Estimate includes the effects on the budget of both higher interest rates and larger totals of outstanding debt than originally forecast.
‡Includes reestimates for farm price supports and offshore oil leases, as well as revisions in estimated tax rates.

The Structural Deficit

(Fiscal years; billions of dollars)

	1983	*1984*	*1985*
Baseline deficit*	**179**	**203**	**218**
Less: Effect of recession, high unemployment	106	89	76
Structural deficit	**74**	**114**	**142**
Memo: Deficits as percent of GNP			
Baseline	5.6%	5.8%	5.7%
Cyclical deficit	3.3%	2.5%	2.0%
Structural deficit (excluding Congressional action)	2.3%	3.2%	3.7%

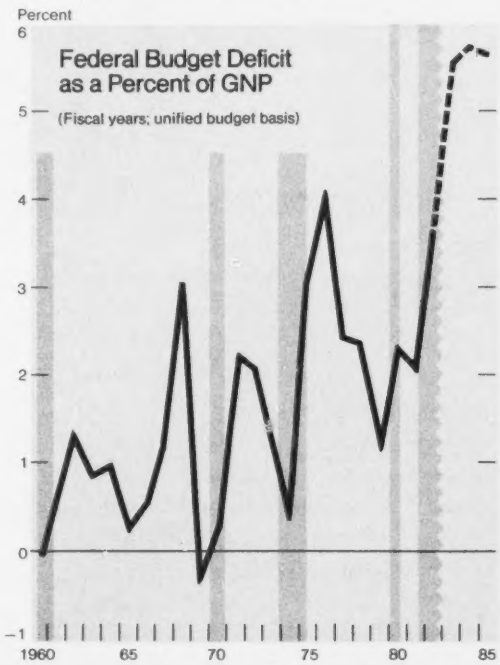
*Morgan estimate of deficit that would result in the absence of policy changes and assuming current programs are continued at present levels.

being able to accommodate tax reductions and defense increases out of curtailment of nondefense spending have not been realized. In part, that is because the Administration and Congress did not follow up on a vast array of promised but unspecified budget cuts. And even more important, Congress has been less than fully supportive of targeted reductions proposed by the Administration. For example, of the close to $400 billion in budget curtailment which the Administration proposed for the four years ending with fiscal 1985, less than half has been approved by Congress. In retrospect, it is clear that the Administration's tax and defense proposals were advanced within the context of unrealistic projections of what could be achieved by way of expenditure cuts.

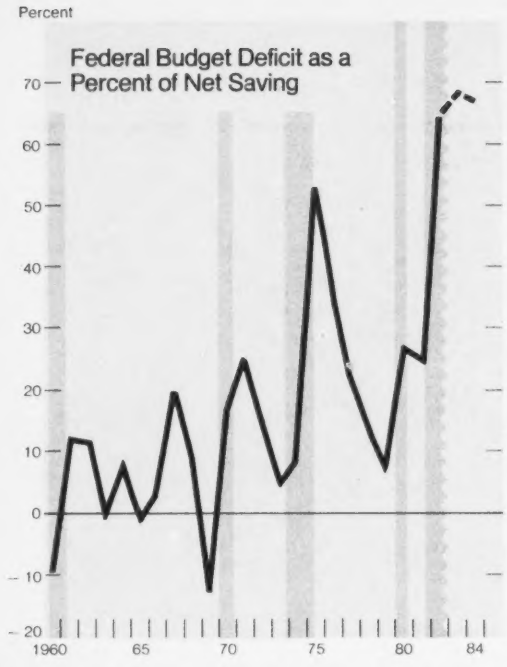
The structural element

Obviously, if the economy were now operating at relatively full employment, tax receipts would be a good deal higher than they are and income-maintainance expenditures considerably lower. For instance, calculations indicate that if the economy were operating with 6% unemployment—the level that today is generally thought to represent reasonably full employment—the deficit would be some $100 billion lower than it is likely to be in the current fiscal year. Similar high-employment calculations produce cyclically adjusted budget deficits that are below baseline calculations by roughly $90 billion in 1984 and $75 billion in 1985 (table on this page).*

*Estimates of how much smaller the deficit would be if the economy were operating at reasonably full employment (table on this page) differ, of course, from estimates of how the deficit has been increased by an evolution of economic activity, inflation, and interest rates different from that forecast by the Administration in 1981 (table on page 3). Among other things, implicit in current high-employment deficit estimates is a much lower rate of inflation.



Note: Shaded areas represent periods of recession as determined by the National Bureau of Economic Research, except for that beginning in 1981, whose terminal date remains open. Plottings for the 1983-85 period are Morgan Bank baseline estimates.



Note: Shaded areas represent periods of recession as determined by the National Bureau of Economic Research, except for that beginning in 1981, whose terminal date remains open. Plottings for the 1983-84 period are Morgan Bank baseline estimates.

Net saving is equal to retained corporate profits, personal saving, state and local government surpluses, and net foreign investment.

In measuring the budget problem, it is important to take account of the large cyclical element in the deficit estimates—that is, the portion of the deficit that would melt away with a return of prosperity. Otherwise, the problem looms so large as to make corrective action seem hopeless.

Even so, the budget problem is grave. The structural deficit exhibits a rising tendency, climbing to about 3¾% of GNP in fiscal 1985 (table on page 4). Only once in the past two decades has the total budget deficit (cyclical and structural elements combined) been that high —(chart on page 4). This deterioration, of course, is mainly due to the large increases in defense spending (rising at a projected 16% annual rate in nominal terms since 1981) and to the impact of the scheduled tax reductions and of lower rates of inflation on tax receipts. What is perhaps even more ominous about the rising trend in the structural deficit is the implication that Treasury deficits will absorb an unprecedented share of total national saving in the next three years (chart on this page). A serious concern is whether such massive Treasury borrowing could actually take place without choking off economic expansion.

Moving toward balance

Despite a recent flurry of announcements by Administration officials suggesting possible spending cuts and new taxes (put forth without the President's final commitment), the potential for stalemate continues to exist. So far, Congressional reaction has been decidedly mixed, and it is not at all clear how quickly, if at all, decisive deficit-reducing actions will be taken. Indeed, the political dialogue to date suggests that the threat to the health of the economy from continued huge deficits is not adequately appreciated. The most immediate risk is that financial market participants will grow reluctant, as they have before, to acquire and hold debt securities. They might fear that the Federal Reserve will eventually face two policy options—neither of which would be good news for bond holders. One option might be to monetize a significant portion of the Treasury's deficits, thereby enlarging the money supply and adding to inflation pressures. The other option might be to resist accommodation of the deficits, letting the combined demand for credit—both government and private—bring about a rise in interest rates.

Failure to act decisively—and convincingly—to reduce federal deficits, thus, runs a clear risk of building fears in financial markets. That risk

Ways to Cut the Deficit

(Fiscal years; billions of dollars)

	1983	*1984*	*1985*
Spending			
Recalculate defense outlays based on lower inflation rate	3.0	4.0	5.0
Reduce cost-of-living adjustments (COLA) for working-age military retirees	—	0.2	0.5
Delay July 1983 Social Security COLA for three months	2.0	2.3	2.4
Reduce Social Security COLA to 80% of change in consumer prices	5.1	6.0	6.9
Alter Medicare coinsurance charges	—	1.1	1.3
End general revenue sharing for fiscally sound jurisdictions	0.7	1.0	1.1
Revenues			
A 2% federal consumption tax	—	20.0	22.0
Advance 50% of scheduled Jan. 1985 and 1986 Social Security tax rate increases to Jan. 1984	—	5.4	3.1
Increase premiums on supplementary insurance under Medicare	—	1.2	1.8
Eliminate indexing provisions of 1981 Tax Act	—	—	11.0
Phase-in end to consumer-interest deductibility and to deductions of sales taxes	—	0.7	9.0
A 5% excise tax on oil products	—	8.0	9.0

is bound to grow if the next few months do not produce a break in the budget stalemate.

If, on the other hand, an attitude of compromise should develop in coming months, there is a large number of options for solving the budget dilemma. These range from a "freeze" on broad categories of government spending (with a maximum potential yield running to something like $35 billion) to a piecemeal approach. The accompanying table lists some of the ways spending could be cut and revenues raised.

New taxes, quite probably, will be necessary to reduce towering deficits. Any new levies need to avoid discouragement of saving, investment, and work effort. Given such imperatives, an approach deserving of consideration would be a broad tax on consumption. For example, a 2% federal consumption levy, which excluded food, clothing, and housing, would yield an estimated $20 billion annually. At a time when billions in income are escaping unreported in the "underground economy," a consumption tax (of the sales tax variety) also would have the added benefit of reducing major tax evasion.

Economy Watch

THE economy is showing signs of improvement. Though real GNP fell in the quarter just ended (table on this page), the decline can be traced entirely to reductions in business inventories. Final sales actually rose an estimated 2% at an annual rate, the best performance in almost two years.

Other encouraging signs include the continued rise in the index of leading indicators and the continued decline in initial claims for unemployment insurance. In December, such claims were down about 20% from the peak September-October level.

The dominant factor in the fourth-quarter reduction of inventories was the auto industry, as it slashed output and boosted sales through concessionary financing. The combination left auto dealers with close to their normal two-month supply at yearend, compared with a three-month supply at the end of October. With car stocks reduced, the industry plans to raise auto output by 20% in the current quarter over the final quarter of 1982—an increase that would bolster real GNP by at least 1% at an annual rate.

With some improvement in the economy in store for the current quarter simply because inventory drawdowns are unlikely to be maintained at their recent pace, a key question is whether recovery, once under way, will be sustained. Similar recovery impetus was imparted to the economy last spring and summer by an inventory swing, but because there was no follow-through in final sales the economy slumped back in the fall.

Prospects now, however, are brighter. The major drags on output last spring and summer came from declining business investment and deterioration in this country's net-export position (table on page 8). Weakness in these two categories persists but is less pronounced. Positive influence on the investment decline can be expected from recent improvement in corporate profits and some indication that capital-goods orders have passed their low point. The recent rapid drop in the exchange value of the dollar (amounting to 5% on a trade-weighted basis since early November) should help in time to slow the decline in this country's net-trade position. U.S. exports to Mexico, in particular, will not continue their steep decline; they fell from $18 billion in 1981 to an annual rate of $6 billion last November.

Declines in interest rates, moreover, have put housing on firmer footing and also stimulated some improvement in demand for consumer

Economic Projections

(Percent change at annual rate from previous quarter, except where noted)

	1982	*1983*			
	Q4	*Q1*	*Q2*	*Q3*	*Q4*
Real GNP	−2.2	2.9	2.7	4.2	4.9
Real consumer spending	2.3	2.8	2.4	3.8	4.3
Real business-capital outlays	−11.1	−9.4	0.2	3.0	4.5
GNP deflator	5.3	4.5	5.1	4.5	5.0
Consumer prices	2.9	2.7	5.6	5.8	5.6
Real disposable personal income	−1.6	2.7	0	4.4	4.2
Saving rate (%)	6.1	6.1	5.5	5.7	5.7
Housing starts (Millions)	1.3	1.4	1.5	1.6	1.6
Auto sales (Millions)	8.6	8.8	8.9	9.4	9.7
Unemployment rate (%)	10.7	11.0	11.2	11.3	11.3

GNP and Components

(Billions of 1972 dollars)

	Change from Q1 1982 to Q3 1982	Change from Q4 1982 to Q2 1983
GNP	10.4	20.4
Inventory investment	18.8	12.8
Final sales	−8.3	7.5
Consumption	7.2	12.5
Durables	−1.1	5.1
Other	8.3	7.4
Business investment	−8.6	−3.8
Housing	0.6	5.4
Net trade	−9.4	−5.1
Government purchases	1.9	−1.6

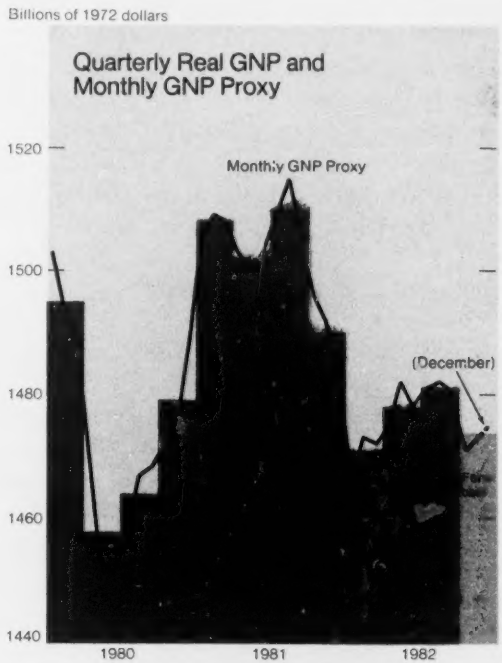
durables—nonautos as well as autos. Neither housing nor consumer durables showed significant strength last spring and summer.

Role of the consumer

Other spending by consumers probably will not contribute significantly to economic recovery in 1983, in large part because growth of personal income has begun to deteriorate noticeably. Consumer interest income has barely risen in recent months, compared with a rise of $10 billion in the first half of 1982. The reason, of course, is that interest rates have fallen. Private-sector wage and salary income also has begun to fall, reflecting widespread cost-cutting efforts by business. Layoffs and wage freezes associated with these efforts led to a decline of $6 billion in the annual rate of private wage payments in the three months ended November. In addition, higher excise taxes on tobacco, telephone calls, gasoline, and airfares will reduce consumer purchasing power by about $8½ billion at an annual rate in the first few months of the year.

Reflecting these influences, growth of real disposable income is likely to be 1½ percentage points lower than real GNP growth in the first half of this year. In contrast, income growth outpaced GNP growth by an average annual rate of 2½ percentage points in the past seven quarters.

All in all, the upturn in the economy that is now starting seems likely to have more staying power than was the case last spring and summer. But with weakness in personal income, as business continues to stress cost-cutting, the recovery in its initial stages probably will be moderate compared with the typical pattern.



Note: Proxy is derived by interpolation from quarterly GNP (actual and projected) on the basis of available monthly data.

Credit Markets in 1983

DESPITE unusually heavy borrowing by the U.S. Treasury, financial markets seem likely to take credit demands in stride in 1983.

Business-sector credit needs are expected to shrink by some $30 billion, reflecting mainly improved corporate cash flow and lessened inflation. But stepped-up borrowing by the federal government will more than offset this decline. All in all, net new credit demands this year are forecast to reach approximately $515 billion, up 4% from 1982 extensions. That small rise is in line with this bank's forecast of a modest economic recovery.

The supply of funds in 1983 will come from more traditional sources than in 1982. For example, commercial banks and thrifts are expected to extend relatively more credit (chiefly because of the new money-market deposit accounts) while the supply from money-market funds will contract.

The tables on this and the next page show the projected demand for credit and where the funds might come from.

Federal borrowing. As detailed in the lead article in this issue, federal borrowing needs in 1983 will almost certainly shatter all records—reaching $180 billion, up $26 billion from 1982. Borrowing by federally sponsored agencies will decline from 1982's fast pace—principally because expected strong deposit inflows to thrifts will reduce their need for agency funds.

State and local borrowing. Some types of state and local borrowing are projected to rise (to finance modestly higher capital spending) while other types are expected to decline (for certain types of targeted investment such as pollution-control projects). The net result: $40 billion in tax-exempt financing—a decline of $12 billion from the extraordinarily high rate in 1982. Last year's volume was unusually large, in part reflecting uncertainties arising from proposed regulatory changes. Among them: a change in the tax treatment of banks' interest expense incurred in carrying municipal bonds; new constraints on the issuance of industrial

The Demand for Credit

(Billions of dollars)

	1977	*1978*	*1979*	*1980*	*1981*	*1982**	*1983**
Federal government issues	57.6	55.1	38.8	79.8	87.8	154.0	180.0
Federal agency issues	22.3	35.3	46.0	43.1	44.8	63.0	47.0
State and local government issues	21.9	28.4	29.8	35.9	32.9	52.0	40.0
Corporate and foreign bonds and notes	36.1	31.8	34.2	41.2	28.5	35.0	50.0
Other business credit (nonfarm)	66.4	84.6	117.9	76.9	123.3	83.0	40.0
Mortgages	129.9	151.0	162.4	134.0	115.2	86.0	120.0
Consumer credit	40.2	48.8	45.4	4.9	25.3	14.0	23.0
All other credit	15.1	36.7	23.1	34.7	27.4	7.0	15.0
Total credit demand	389.6	471.8	497.6	450.4	485.2	494.0	515.0

*Estimated. Due to rounding, components may not add to totals.

Possible Sources of Funds

(Billions of dollars)

	1977	*1978*	*1979*	*1980*	*1981*	*1982**	*1983**
Commercial banks	87.6	128.7	121.1	99.7	103.5	114.0	130.0
Savings institutions	81.6	73.6	55.5	54.1	24.6	27.0	50.0
Life insurance and pension funds	51.5	58.4	53.0	64.5	68.9	78.0	95.0
Money-market mutual funds	−0.1	3.2	19.8	14.9	62.5	30.0	−5.0
Other financial institutions	41.2	38.9	42.8	24.8	41.8	26.0	20.0
Nonfinancial corporations	8.7	4.6	22.8	11.9	7.3	21.0	20.0
Governments, including Federal Reserve	47.6	64.5	91.4	87.1	83.1	91.0	90.0
Foreign investors	39.6	38.0	−4.6	23.2	16.6	22.0	25.0
Individuals and others	31.9	61.7	95.7	70.2	76.9	85.0	90.0
Total credit supply	389.6	471.8	497.6	450.4	485.2	494.0	515.0

*Estimated. Due to rounding, components may not add to totals.

revenue bonds;* and requirements that securities be issued in registered form.† In addition, declines in interest rates boosted tax-exempt bond issuance last fall and will continue to do so through the first half of 1983.

Corporate financing. Corporations' external funding needs are expected to decline in 1983. That's because current-dollar investment in new plant and equipment and inventory accumulation is forecast to expand very modestly in the year ahead, partly due to underutilization of existing capacity. In addition, a pickup in economic activity and a solid rise in productivity will boost corporate profits (and hence internal funds) this year. Interest expense of corporations will decline dramatically in 1983, reflecting the rolling over of short-term liabilities at much lower rates. (In each of the previous three years interest expense had risen by $10 billion.*) Finally, the 1981 tax cuts will add some $10 billion to corporate cash flow in 1983. The net result is that long- and short-term corporate borrowing combined is projected to decline by some $30 billion.

As is typical in the early stages of a recovery, many corporations can be expected to make vigorous efforts to restructure their balance sheets. Sales of common stock will likely be on the increase as will issuance of bonds.† But net bond issuance will probably account for a smaller portion of total credit extensions in 1983 than in the typical initial year of recovery. Diminished prospects for further capital gains will do little to augment coupon returns that are still handsome by historical standards. That will moderate investors' appetites for acquiring long-term debt.

*For example, as of the beginning of this year, many investment projects eligible for financing with industrial revenue bonds can take advantage of either tax-exempt financing or accelerated depreciation under the 1981 tax law, but not both as in 1982.

†Last month, Congress pushed forward the registration requirement to July 1, 1983 from the original January 1 effective date.

*"The Effects of Lower Interest Rates," *The Morgan Guaranty Survey*, December 1982.

†Net equity issuance is not included in the borrowing totals in the table on page 9. They include credit-market instruments only.

The growth in short-term business borrowing (identified in the table on page 9 as "other business credit")—bank and finance company loans, commercial paper, bankers' acceptances, and net trade credit—will fall off sharply from 1982's pace as increased emphasis is placed on balance-sheet restructuring.

Other borrowing. Mortgage credit flows are likely to climb sharply this year, but to a pace well below that of the late 1970s. Reflecting continuing declines in mortgage rates, housing starts in the Morgan forecast rise to a 1.6-million annual rate by yearend, contributing to a 40% jump in net new-mortgage debt.

Consumer credit will expand in the year ahead, reflecting mainly a projected rise of 14% in new car sales. But continuing consumer trepidation—in view of high unemployment—is expected to hold credit demands below the pace of earlier recoveries.

Summing up

Financial markets should be able to handle credit demands without much strain in 1983. Record borrowing by the government will be coming at a time when new business-sector credit needs will actually be declining.

Toward the end of this year, however, the picture could change as private borrowing begins to rise and the recovery gains momentum. In short, pressures could begin to show up late in 1983 unless action is taken to curb the federal government's appetite for credit.

Natural-Gas Deregulation: Time to Act

NO one seems happy about what is going on in the natural-gas market. Consumers have had to pay rapidly rising bills—prompting an unsuccessful effort in the lame-duck session of Congress to freeze gas prices. Production from many wells has been shut off; some gas, paradoxically, can't be sold at any price, owing to the structure of contracts in the industry.

Pipelines face declining demand as industrial firms, which for several years had been returning to gas as a fuel source, switch back to oil. The reason: the price of gas relative to that of oil has risen 30% in the past year (chart on this page), reaching a postwar high. Overall demand, further dampened by the recession, has fallen about 10% in the past year.

All the while, more petroleum is being imported than would be needed if the nation's gas resources were being fully used. Moreover, high-priced gas is being imported from Canada at a time when cheaper U.S. supplies can't find buyers. Clearly, natural-gas policy needs high-priority attention from the new Congress.

The root cause

Problems in the gas market are caused by the interaction of inflexible federal price controls and rigid contracts between pipeline companies and producers—contracts that themselves were by-products of a long history of federal regulation.

The average price of gas at the wellhead has risen 20% in the past year. The rise reflects the workings of the Natural Gas Policy Act (NGPA) of 1978, the basic law governing the industry. Under its terms, the price of most gas is allowed to rise each year by the rate of inflation, and, in the case of gas from relatively new finds, by four percentage points above it. Moreover, prices also are rising because less gas is being produced in categories with low price ceilings under the NGPA (typically gas from older wells which are being exhausted) and more is being produced in categories with high ceilings (typically gas from newer wells).*

So-called take-or-pay contracts have added to price pressures. These require, in essence, that pipelines take minimum quantities of gas or else pay for gas not purchased. As a result,

*A fuller discussion of how the price controls work is contained in "Natural Gas Decontrol: Issues and Prospects," *The Morgan Guaranty Survey*, March 1982.

Note: Relative price is the Producer Price Index (PPI) for natural gas divided by the PPI for residual oil. The last plotting is for November 1982. Consumption share is the share of gas in industrial use of oil and gas combined (BTU basis). The 1982 plotting is the average for the first eight months.

pipelines draw on relatively high-priced gas they are obliged to take under contract while not drawing on comparatively low-priced gas covered by contracts whose take-or-pay provisions tend to be less restrictive. Take-or-pay contracts with Canadian producers help explain why high-priced gas from Canada continues to flow while many wells in this country are shut down.

Search for a solution

The basic problem in the industry is the same today, with gas in surplus, as it was during the mid-1970s, when shortages were widespread. The trouble is that federal regulation is too rigid to allow gas prices to reflect changing conditions. What is needed is a move to more flexible prices.

A year or so ago when price decontrol was getting high-level attention in the Administration, a key objection to such action was that it would result in sharply higher prices. That presumably was why President Reagan concluded that Congress would not act on his decontrol program and set it aside. But today, with gas prices at levels that have provoked switching back to oil and an estimated 15% of capacity idle, it is not clear that a sharp runup in prices would result if the gas market were deregulated.

One issue that would have to be faced with decontrol, however, is what to do about existing contracts between pipelines and producers. During the mid-1970s, with gas in short supply largely because of low price ceilings, controls prevented pipelines from competing for supplies on the basis of price. It was then that strict take-or-pay provisions became common. And it was also at that time that producers succeeded in getting favorable price-escalator clauses in contracts. Such clauses, in general, tied gas prices to oil prices or to the highest price paid for gas in a given field in the event price controls were ever removed.

With decontrol, such contracts would present major problems for the industry. The price of most of the relatively cheap gas would rise quickly to market levels. But gas that is now high-priced might be slow to adjust to market levels because of escalator clauses in existing contracts. In that event, pipelines would for a time be saddled even more than they are now with unmarketable, high-priced gas.

This problem would not exist under contracts drawn very recently. Market forces, and the prospect of partial decontrol in 1985 under the NGPA, have led to more flexible arrangements. They give pipelines more leeway to turn down, without penalty, gas flows that cannot be marketed economically. Decontrol would accelerate this process.

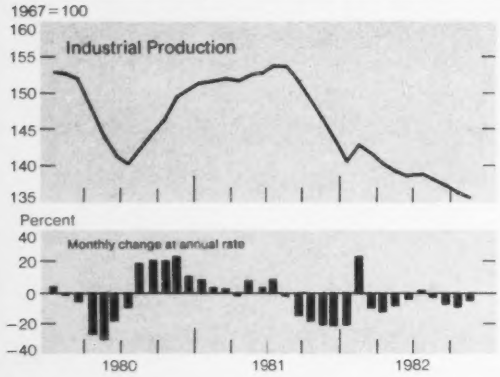
Easing the transition

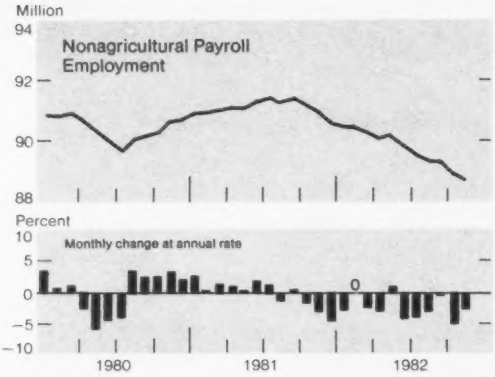
The problem of adjusting to decontrol, however, would still exist because the vast majority of gas is sold under older contracts. Given the potential for further market distortions and the fact that older contracts were shaped by past government policies, there may well be a role for government in easing the transition to decontrol. The Federal Energy Regulatory Commission (FERC), in fact, has taken several actions aimed at encouraging more market responsiveness in pricing. It recently discouraged pipelines from increasing their Canadian imports. And it effectively limited take-or-pay provisions in new contracts to 75% of potential volume. A FERC administrative law judge, meanwhile, recommended that the Commission disallow the pass-through of some costs incurred by pipelines under existing contracts.

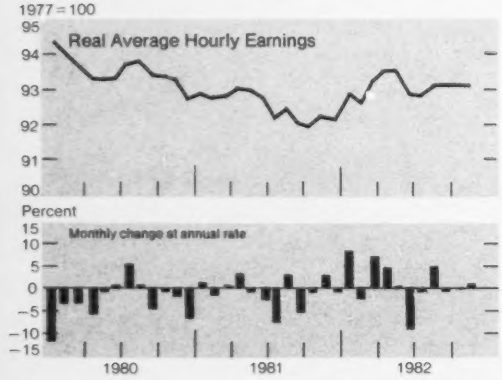
Other actions may be needed to reduce distortions in the market. Chief among these would be steps aimed at forcing prices to adjust to market reality rather than conforming to contract terms agreed to in an unrealistic regulatory environment.

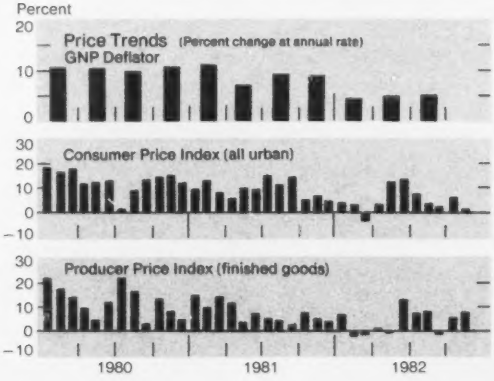
The current situation provides a unique opportunity for reform. Action must be based on recognition that problems in the gas market are the inevitable result of the rigidities of regulation and that a market-oriented system would be far more efficient. The successful decontrol of oil prices two years ago provides the model.

ECONOMIC INDICATORS









Note: All data are seasonally adjusted. Hourly earnings are adjusted for overtime in manufacturing and for interindustry employment shifts.

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